THE CITY OF LONDON LAW SOCIETY'S FINANCIAL LAW COMMITTEE

RESPONSE TO THE PROPOSALS FOR A UK RECOGNISED COVERED BONDS LEGISLATIVE FRAMEWORK MADE BY HM TREASURY AND THE FINANCIAL SERVICES AUTHORITY (THE "FSA") IN JULY 2007 (THE "PROPOSALS")

1. Introduction

1.1 The City of London Law Society ("CLLS") represents approximately 12,000 City lawyers, through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues.

1.2 The CLLS responds to Government consultations on issues of importance to its members through its 17 specialist Committees. A working party of the CLLS Financial Law Committee, made up of solicitors who are experts in their field, have prepared the comments below in response to the Proposals.

1.3 The members of the working party comprise:

Robin Parsons	-	Sidley Austin LLP (Chairman of the working party)
John Davies	-	Simmons & Simmons
Alan Newton	-	Freshfields Bruckhaus Deringer
Jim Rice	-	Linklaters LLP

2. Scope of our response

2.1 This response deals only with the insolvency aspects of the Proposals. We are aware that other interested parties are responding to other aspects of the Proposals.

2.2 Most of our substantial comments relate to the integrated model. What we think the regulations set out in Annex A to the Proposals (the "Regulations") should set out to do in relation to the integrated model is to start with a general provision that the asset pool and the covered bond liabilities should be deemed to be the assets and liabilities of a separate "cell", and in this respect the Regulations could draw upon the protected cell legislation that has been enacted by Jersey[1], Guernsey[2] and Gibraltar[3]. The legislation in Jersey provides that where a protected cell company ("PCC") enters into a transaction in respect of a particular cell of the company, a claim by any person in connection with the transaction extends only to the cellular assets of the cell and a PCC has no power to meet

[1] The Companies (Amendment No. 8) (Jersey) Law 2005 (the "2005 Law"). There is a proposal to amend the 2005 Law : a draft of the Companies (Amendment No.2) (Jersey) Registrations 200 – has been circulated for comment.
[2] The Protected Cell Companies Ordinance, 1997 as amended by the Protected Cell Companies (Amendment) Ordinance 1998 (the "1997 Ordinance").
[3] The Protected Cell Companies Ordinance 2001.

any liability attributable to a particular cell from the non-cellular assets of the company.[4] The legislation in Guernsey provides[5] that the assets of a PCC shall be either cellular assets or non-cellular assets and that it shall be the duty of the directors of the PCC to keep them separate and separately identifiable. The assets attributable to the cell of a PCC are only available to the creditors of the company who are creditors of that cell and those assets are absolutely protected from other creditors of the PCC.

2.3 If the Regulations are made in the form proposed in Annex A to the Proposals, there is a risk in our view that the integrated model will not be used at all in part, at least, because the ring-fencing provided for in the draft Regulations is not fully effective. It is likely that there will be a strong preference for the SPV model. The SPV model is tried and tested in the U.K.,[6] and the main advantage of the new legislation will be to allow this tried and tested model to benefit from the higher prudential investments limits allowed for by the UCITS Directive.[7]

2.4 This response begins by highlighting insolvency issues that arise in relation to the integrated model and the SPV model. It then moves on to insolvency issues affecting both models. This is followed by drafting points on the draft Regulations. Finally, there is a summary of our main conclusions.

3. The integrated model

3.1 The general approach taken in the draft Regulations is to provide that the claims of the covered bond creditors should rank first on the asset pool, to prohibit dealings with the asset pool by a liquidator or administrator and to exclude the asset pool from the scope of any voluntary arrangement or scheme of arrangement proposed by the owner/issuer.[8]

3.2 This is not in our view sufficient to achieve a proper ring-fencing of the asset pool and the covered bond liabilities.

3.3 The owner/issuer is required to be a U.K. credit institution.[9] HM Treasury and the FSA have invited comments on this restriction and indicate[10] that, unless they can be satisfied that robust enforcement can be delivered to the owner/issuer with a registered office in some other EEA state, they do not propose to relax the restriction. Except where the SPV model is adopted, we consider that it is essential that the restriction be retained in order to ensure that within the European Union the only jurisdiction in which a reorganisation measure or winding up proceedings can be commenced is within the U.K..[11] Whatever ring-fencing is provided for by the Regulations can only be effective if

[4] Article 29 of the 2005 Law substituting a new Part 18D to the Companies (Jersey) Law 1991: section 127 YT.
[5] Sections 3 and 4A of the 1998 Ordinance.
[6] We understand that there have been eight covered bond issuers in the U.K., the first of which was HBOS plc.
[7] Council Directive 85/611/EC.
[8] See Part 6 of the draft Regulations and Schedule 1.
[9] Regulation 6(2).
[10] Paragraph 2.6 of the Proposals.
[11] The Credit Institutions Reorganisation and Winding up Directive 2004 (2001/24). If the home state of the credit institution were in a Member State of the European Union other than the U.K., Article 10 would require the courts of each Member State to apply "the laws, regulations and procedures applicable in [the non-U.K. credit institution's] home Member State insofar as [the] Directive does not provide otherwise. Accordingly, the effectiveness of the Regulations (and therefore in practice the availability of the integrated model) will be limited to U.K. credit institutions.

and to the extent that any insolvency proceeding is a proceeding conducted under English law or under the law of another part of the U.K. Where the SPV model is adopted, we see no reason why the issuer need be a U.K. credit institution, and if the FSA is satisfied that they have sufficiently robust powers of enforcement, the issuer could be any credit institution with its head office or a branch office situated in the U.K. (We recognise that if the issuer is also the originator of the assets and its head office is outside the UK, then where the SPV model is adopted it will be necessary to consider such matters as the undervalue and clawback provisions and the law relating to corporate benefit applicable in the jurisdiction of the head office).

3.4 It is not clear to us from the draft Regulations whether, where the integrated model is used, it is contemplated that the asset pool will be subject to a security interest in favour of a security trustee for the covered bond creditors. If the assets are sufficiently ring-fenced and located in the U.K., arguably no security interest would be needed (the position of the covered bond creditors with regard to the asset pool being analogous to the position which is achieved by the taking of a security interest). In practice, we think it possible that, even if the ring-fencing is strengthened, the parties may wish the claims of the bondholders and of the service providers to be secured as security also confers a degree of control. Such ring-fencing as there is under the Regulations only applies in an insolvency proceeding[12] and unless the ring fencing position is improved, where the integrated model is used, security would have to be taken over the asset pool in order to ensure priority over, for example, an execution creditor of the company[13].

3.5 Where the integrated model is used and the capital market exemption[14] would apply if the SPV model had been used, the draft Regulations do not allow for the appointment of an administrative receiver to be appointed to the asset pool. The asset pool should be regarded as the assets of a separate company for the purpose of determining whether the security interest taken to secure the covered bond liabilities constitutes the whole or substantially the whole of a company's property, thus permitting the holder of the security interest to appoint an administrative receiver[15] or an administrator.[16] Accordingly, express provision should be made in the relevant legislation to allow the appointment of an administrative receiver or an administrator in these circumstances. In

[12] Regulation 22 relates to voluntary arrangements and schemes of arrangement which strictly may be proposed outside of an insolvency proceeding and administrators and receivers dealt with by Regulations 23 and 27 can be appointed out of court.

[13] Strictly, Article 22(4) of the UCTIS Directive only requires the bondholders to have priority over the asset pool "in the event of failure of the issuer". As currently drafted, there would be nothing to prevent an execution creditor enforcing a judgment against the issuer/owner over assets in the asset pool, but for the purposes of continuing to comply with the capability test, the issuer/owner would then need to top up the asset pool to its previous level. This prospect would not be acceptable for ratings purposes. Although the ratings analysis of a covered bond is primarily dependent on the covenant strength of the issuer until default, on default it is assumed that a "full asset pool" (i.e. an asset pool which meets the capability test *at that point in time*) will be available to cover the claims of bondholders in full. In the situation of execution being levied against the asset pool, this would not be the case until any top up is made in full. Bondholders would effectively take a credit risk on the issuer/owner in two respects: (i) the ability of the issuer/owner to make payments in full when due under the bonds and (ii) the ability of the issuer/owner to top up the asset pool to the level required for it to comply with the capability test. This risk is taken generally by all bondholders where an asset pool is required to be topped up, but the amounts contemplated to be involved in periodic topping up of the asset pool would be small compared with the potential amount of a top up which would be required after execution of any judgment being levied against an asset pool. It is submitted that the Regulations should avoid exposing bondholders to this greater risk.

[14] Section 72B Insolvency Act 1986.

[15] See the definition of "administrative receiver" in section 29(2) Insolvency Act 1986.

[16] Schedule B1 to the Insolvency Act 1986, paragraph 14.

our view, it should be possible to appoint an administrative receiver or an administrator of the pool assets without making an appointment in relation to the remaining assets of the company.[17]

3.6 Where the integrated model is used, it should be possible to have a liquidator or (unless an administrative receiver is in office) an administrator appointed in respect of the asset pool, but not in respect of the remaining assets of the issuer/owner,[18] and vice versa, so that, for example, the asset pool is not necessarily liquidated merely because the issuer/owner is insolvent (either on a cash flow basis or a balance sheet basis) if the pool assets are sufficient to service the covered bond liabilities and those liabilities are over-collateralised. The wrongful/fraudulent trading provisions[19] of the Insolvency Act 1986 (the "Insolvency Act") would also need to be modified accordingly, and possibly also the duties of the directors as set out in the Companies Act 2006.

3.7 It seems to be intended that, under the integrated model, the covered bond creditors could prove in an administration or liquidation of the issuer/owner and receive a dividend from assets other than the asset pool, and that the remaining creditors of the issuer/owner could prove in an administration or liquidation and receive a dividend from the asset pool, albeit on a subordinated basis.[20] There should be no such cross-over. Each pool of assets and liabilities should be entirely separate.[21] The cross-over would mean that the administrator/liquidator appointed to the asset pool would owe duties to the general creditors of the issuer/owner i.e. the creditors of the remaining pool of assets. This would result in a potential conflict of interest.[22] Separate administrators or liquidators should be capable of being appointed to each pool and those duties would be solely to the creditors of the relevant pool.

3.8 Where an administrator or liquidator is appointed, the Regulations provide[23] that he must not deal with the asset pool except by way of an assignment or transfer of all interests in the assets in the asset pool and the benefit and obligations under all contracts relating to the asset pool. We understand that these obligations include not only obligations to service providers but also obligations under the covered bonds themselves. This somewhat oblique way of dealing with the transfer of the obligations is not in our view entirely satisfactory. It is not clear, for example, what the transfer involves: is it an outright novation so that the issuer/owner is released from the obligations and the transferee assumes identical obligations to the persons to whom the obligations are owed or is it no more than an arrangement whereby, as between the issuer/owner and the transferee, the transferee agrees to perform those obligations? In our view, it would be highly desirable for the Regulations to provide an express mechanism whereby the obligations can be novated. There is no means under English law whereby obligations can be transferred in this sense other than by contractual agreement between all the parties involved (which may not be practicable where there are a large number of

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[17] The PCC legislation would seem to achieve a similar result: see, for example, Parts II and III of the 1997 Ordinance.
[18] This is possible in Guernsey. See section 20 of the 1997 Ordinance.
[19] Sections 213 and 214 Insolvency Act.
[20] Regulation 28.
[21] As appears to be the case in the PCC legislation. See section 4A of the 1997 Ordinance and section 127YT of the Amended (Companies) Law 1991.
[22] The point is referred to in paragraph 2.58 of the Proposals.
[23] Regulations 23, 24 and 25.

covered bondholders[24]) or a scheme of arrangement (which is not permitted by the draft Regulations[25]).

3.9 Where the integrated model is used, the security trustee on behalf of the covered bond creditors (and not just the administrator or liquidator) should be able to assign and transfer the asset pool and covered bond liabilities to a third party and any restriction on the enforcement of the security without the consent of the administrator or the permission of the court[26] should be disapplied.[27]

3.10 There will normally be a degree of over-collaterisation in the asset pool. The entire asset pool (including the over-collateralised portion) should be capable of being assigned or transferred without the transferee providing any consideration other than the assumption of the covered bond liabilities, notwithstanding that this might not be the best price reasonably obtainable for the asset pool. The duties that are owed by an administrative receiver, administrator or liquidator to the company should be modified accordingly. Alternatively, the Regulations should expressly allow all or any part of the consideration (including any additional consideration representing payment for the over-collateralised portion) to be deferred and should also allow the claim for the deferred consideration to be subordinated in any insolvency proceeding affecting the transferee.

3.11 Where the integrated model is used, the provisions of the Insolvency Act that allow the expenses of the administration[28] and that will allow the expenses of the liquidation[29] to rank ahead of any floating charge securing the covered bond liabilities should be disapplied in so far as those expenses relate to an administration or liquidation affecting assets of the issuer/owner other than the asset pool.[30]

3.12 An administrator or liquidator of the issuer/owner should not (without the consent of a majority of the covered bondholders) be able to close-out derivatives contracts (such as any hedging arrangements) which provide essential long or medium term hedging to the holders of the covered bonds but which may nevertheless result in loss to the company if they are allowed to continue (the prohibitions on the administrator or liquidator dealing with the asset pool may not extend to a derivative in respect of which the company is "out of the money").

3.13 The integrated model imposes a somewhat arbitrary time limit of 12 months within which the liquidator must assign or transfer the asset pool and the covered bond liabilities.[31] (There also seems to be a dangerous implication that the ring-fencing will terminate at the end of the "protected period" of 12 months).[32] In the case of an administration, there is a statutory 12 month time limit within which the administration

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[24] It is possible that an express provision could be included in the trust deed or indenture constituting the covered bonds anticipating a transfer of the obligations by an administrator, liquidator or administrative receiver, but it would be much more satisfactory to include a mechanism within the Regulations.
[25] Regulation 22.
[26] Insolvency Act, Schedule B1, paragraph 43(2).
[27] The FSA would no doubt wish to require the third party to comply with its requirements as issuer/owner (see Regulation 9(3)).
[28] Insolvency Act, Schedule B1, paragraph 99(3).
[29] Section 176 ZA of the Insolvency Act as inserted by section 1282 Companies Act 2006.
[30] Regulation 28(2) would need to be amended to deal with this.
[31] Regulation 25(7).
[32] Regulation 25(4).

must be concluded.[33] The time limit applicable to the liquidator may be extended by the FSA, but that applicable to the administrator may only be extended by the court[34] or with the consent of a majority of the creditors[35]. What is an appropriate time limit in any given case will depend upon the circumstances of the case and we would prefer not to have any time limit imposed. However, if it is thought necessary to impose one, we would prefer that the same rule should be applied to administrators and liquidators, that the time limit should be extended to two years and that the FSA be given authority to extend the period of administration.

3.14 Where an issuer/owner creates more than one asset pool (i.e. in relation to two or more recognised covered bond programmes) the assets belonging to each asset pool or "cell" should be sufficiently identifiable by reference to the register of assets maintained for each asset pool.

4. The SPV Model

4.1 We endorse the view of HM Treasury that, where the integrated model is used, the issuer should be a U.K. credit institution. This is important in order to ensure that there is a greater likelihood of any insolvency proceeding affecting the issuer being governed by English law or the law of some other part of the U.K.[36] Where the SPV model is used, this is not essential and we have suggested[37] that, if the FSA are satisfied that they have sufficiently robust powers of enforcement, the issuer could be any credit institution with its head office or a branch office situated in the U.K. We recognise, however, that if the issuer is also the originator of the assets and its head office is located outside the UK, then where the SPV model is adopted it will be necessary to consider such matters as the undervalue and clawback provisions and the law relating to corporate benefit applicable in the jurisdiction of the head office). However, it is important that, where the SPV model is used, the SPV should have and should maintain its centre of main interests ("COMI") in the U.K. and that it should not at any time have any establishment outside the U.K. Under the EC Regulation on Insolvency Proceedings 2000, this will ensure that within the European Union (other than Denmark), main insolvency proceedings can only be commenced in relation to the SPV in the U.K. and that there cannot be territorial or secondary proceedings.[38] If this is not done, there can be no assurance that the amendments to U.K. insolvency law made by the Regulations will have practical effect. We note, however, that the EU Regulation is not applicable to all types of legal entity and that where it is not applicable there may be other criteria which are relevant for the purpose of conferring jurisdiction on the English courts over insolvency proceedings concerning these entities.

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[33] Insolvency Act, Schedule B1, paragraph 76.
[34] Insolvency Act, Schedule B1, paragraph 76(2)(a).
[35] Insolvency Act, Schedule B1, paragraph 76(2)(b) and 78.
[36] See paragraph 3.3 above.
[37] See paragraph 3.3 above.
[38] Article 3.

4.2 The Cross-Border Insolvency Regulations 2006 (the "2006 Regulations") will not generally apply to the issuer as an authorised person[39] but could apply, where the SPV model is used, to the owner SPV. This is another reason for imposing the requirement referred to in paragraph 4.1 above.

4.3 The Proposals provide[40] that it may be appropriate to add assets to the asset pool based on the performance of the assets already contained within it to ensure the necessary level of security for the covered bond creditors. Similarly, where the issuer fails to satisfy a requirement to maintain adequate financial resources imposed under the Financial Services and Markets Act 2000, the issuer is required[41] to assign or transfer all interests in the assets in the asset pool to a person other than the issuer. Finally, the issuer is required[42] to transfer or allocate all sums deriving from the issue of a covered bond to an asset pool or to use such sums to acquire eligible property and to transfer or allocate the eligible property to the asset pool. In each case, the Regulations should protect the person to whom the assets are assigned, transferred or allocated from a claw-back[43] should the person by whom they are assigned, transferred or allocated be or become subject to an insolvency proceeding. (We recognise that such a provision might not be effective where the issuer/originator had its head office outside the UK).

5. Issues affecting either the integrated or the SPV model

5.1 We now deal with general insolvency issues which do not relate specifically either to the integrated or the SPV model.

5.2 "Eligible property" must be situated in one of the countries listed in Regulation 3(2). We think that the rationale for this is questionable. For example, even though the US has implemented the UNCITRAL Model Law, the implementation does not contain a carve-out for security enforcement; the result is that the enforcement of the security will usually be subject to the automatic stay. Further, a UK administrator or liquidator of the issuer will not be able to obtain recognition of the insolvency proceeding in the U.S. under Chapter 15 of the US Bankruptcy Code because Chapter 15 does not apply to foreign credit institutions. In summary, implementation of the Model Law does not guarantee uniformity; much depends upon local legislation. (We recognise also that if assets are in jurisdictions other than the U.K., it may be necessary to investigate further certain issues such as set-off, priority of security over attachments, recognition of transfers made by administrative receivers, rights of administrative receivers etc).

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[39] Article 1(2) of and Schedule 1 to the 2006 Regulations, although there is a proposal that the 2006 Regulations should be extended to cover banks.
[40] Paragraph 2.36.
[41] Regulation 20.
[42] Regulation 13(1).
[43] The relevant claw-back provisions are sections 127 (avoidance of property dispositions, etc), 238 (transactions at an undervalue), 239 (preferences) and 423 (transactions defrauding creditors) of the Insolvency Act. Regulation 51(2)(g) disapplies section 239 to any allocation to the asset pool, but not any transfer to the asset pool. This may have significance if our suggestion is accepted that, where the integrated model is adopted, the asset pool and the covered bond liabilities should be deemed to be the assets and liabilities of a separate "cell". Moreover, sections 238 and 423 are not disapplied.

5.3 A policy decision has to be made regarding the applicability of administration[44] and liquidation[45] set–off. This issue is relevant to the securitisation of receivables generally and is not confined to covered bond structures. Our view is that, if there is no express provision disapplying set-off, any potential problem could be dealt with (as happens at present) by an over-collateralisation of the covered pool. We express no view on what the policy of HM Treasury and the FSA should be on this point.

6. Drafting Points

6.1 This response deals with points which are of a drafting nature but which may nevertheless be of practical significance.

6.2 In relation to the definition of "asset pool" in Regulation 2, it should be made clear (a) that sums or eligible property transferred or allocated to the asset pool by way of over-collateralisation are included, and (b) that any rights acquired by the owner under derivative contracts (such as hedging arrangements) and contracts of insurance relating to the asset pool are included and that the obligations under contracts relating to the asset pool should include liabilities under such contracts.[46] It may also be desirable to state in express terms that those obligations include the covered bond obligations themselves.

6.3 The provisions of the Insolvency Act that are disapplied by the Financial Collateral Arrangements (No. 2) Regulations 2003 in relation to the enforcement of security in financial collateral should be disapplied by the Regulations in relation to the enforcement of security on the asset pool.

6.4 Where security is taken, Regulation 28(3) is confusing in that it provides that the claims of the covered bondholders and the service providers have priority over the claims of the holders of fixed or floating charges created by the issuer/owner over the asset pool. This should be expressed to apply to security only if and to the extent that the claims of the covered bondholders and the service providers are not themselves secured by that security.

6.5 Regulation 13(1) should allow sums to be transferred to the asset pool by way of loan or by way of a subscription for shares, where the SPV model is used.

6.6 The claims of the covered bond creditors rank ahead of preferential creditors on a receivership or liquidation (Regulations 27 and 28); the principle needs to be extended to cover a case where the security trustee takes possession.[47] Incidentally, where a receiver is appointed, the holder of the charge does not take possession and Regulation 27 needs to be corrected in this respect. The two situations (the appointment of a receiver dealt with under section 40 of the Insolvency Act and the chargee taking possession dealt with under section 196 of the Companies Act 1985) should be disentangled.

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[44] Rule 2.85 Insolvency Rules 1986.
[45] Rule 4.90 Insolvency Rules 1986.
[46] See paragraph 2.35 of the Proposals.
[47] Section 196 Companies Act 1985 (as currently applied to limited liability partnerships pursuant to Regulation 4 and Part I of Schedule 2 to the Limited Liability Partnerships Regulations 2001).

6.7 It could be emphasised that the claims in Regulation 28(1)(a) (recognised covered bondholders) and Regulation 28(1)(b) (persons providing services for the benefit of bondholders) rank equally. To the extent permissible under the UCITS Directive, this should be amended to make the position clear and to allow *pari passu* ranking to be disapplied by agreement between the relevant parties. With certain exceptions, it is market practice in the U.K. for the service providers to be paid first on a pre-enforcement as well as on a post-enforcement priority of payments. Are claims referred to in Regulation 28(1)(b) incurred after the commencement of a winding up intended to be included as liquidation expenses? If so, could this be made clear?

6.8 Regulation 28(2) provides that, if the asset pool is insufficient to meet the claims of bondholders and the specified transaction parties, those claims "shall abate in equal proportions." This may mean that the holders of those claims would have no residual right to recover dividends in the liquidation from other assets of the owner. Whilst this is our preferred position (see paragraph 3.7 above), the drafting in this respect is not clear. The general position would appear to be that, absent any limited recourse clause or any provision in the Regulations preventing them from doing so, the bondholders would have the right to prove in the liquidation, *pari passu* with other general unsecured creditors, for any claim not fully satisfied from dividends paid out of the asset pool.

6.9 The asset pool could be subject to a security interest for the benefit of covered bond creditors. As drafted, the treatment of covered bond creditors seems more like the treatment of preferential creditors in respect of floating charge assets.

6.10 Regulation 26(2) is ambiguous when it says "the issuer holds any interest on behalf of the owner in an asset". If it means legal title, we think that it should say so.

6.11 Regulation 25(4) appears to be conceptually confused. It is sufficient if the asset pool is dealt with in a specified manner, albeit that the assets in question are assets of the issuer/owner in liquidation.

6.12 Why does Regulation 50 refer to the pre-Enterprise Act administration regime?

7. Main conclusions

7.1 Those provisions of the Regulations which attempt to establish an integrated model in our view need substantial redrafting and we would recommend that the starting point should be the PCC legislation in Jersey or Guernsey.

7.2 If it is not possible to do this within the timescale under which the new legislation is required to be implemented, we recommend that attention is given to the points which we raise on the SPV model and further attention can be given to the provisions that deal with the integrated model over the course of time.

Financial Law Committee
The City of London Law Society
17 October 2007